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No. 96-1127

IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

UNITED STATES OF AMERICA,
Petitioner,

v.

EXXON CORPORATION AND SUBSIDIARIES,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

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BRIEF FOR RESPONDENTS IN OPPOSITION

ROBERT L. MOORE, II
Counsel of Record
THOMAS D. JOHNSTON
EMMETT B. LEWIS
ALAN I. HOROWITZ
MILLER & CHEVALIER,
Chartered
Metropolitan Square
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 626-5800

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

QUESTION PRESENTED

Whether Treas. Reg. § 1.613-3(a) should be construed as directing use of a "representative market or field price" only when that price is lower than the taxpayer's actual sales proceeds for oil or gas sold away from the well, notwithstanding the regulation's unequivocal command that "the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation."

RULE 29.1 STATEMENT

Exxon Corporation has no parent company. The following affiliates of Exxon Corporation are publicly held.

Compania Minera Disputada de las Condes S.A.
Esso Malaysia Berhad
Esso Societe Anonyme Francaise
General Sekiyu K.K.
Imperial Oil Limited
Les Docks des Petroles d'Ambes
Societe Francaise EXXON CHEMICAL
Tonen Kagushiki Kaisha

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BRIEF FOR RESPONDENTS IN OPPOSITION

STATEMENT

1. This case is governed by Treas. Reg. (26 C.F.R.) § 1.613-3(a), a legislative Treasury regulation that has remained substantially unchanged since its promulgation in the 1920s. As applicable to the 1974 taxable year, section 611 of the Internal Revenue Code (26 U.S.C.) provides that a taxpayer shall be allowed a "reasonable allowance for depletion . . .; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate." Section 613(a) provides

that, for oil and gas properties, that depletion allowance shall be a specified percentage of the taxpayer's "gross income from the property." That latter term is then defined by Treas. Reg. § 1.613-3(a).[1]

The regulation establishes two distinct methods for determining "gross income from the property," depending upon whether the oil or gas is sold in the vicinity of the well. It provides:

> In the case of oil and gas wells, "gross income from the property," as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. *If the oil or gas is not sold on the premises* but is manufactured or converted into a refined product, or is transported from the premises prior to sale, *the gross income from the property shall be assumed to be equivalent to the representative market or field price* of the oil or gas before conversion or transportation.

Id. (emphasis added). Thus, if the oil or gas is sold at the well, "gross income from the property" is based on the actual sales price. But, in a case like this one, where the oil or gas is transported from the premises prior to sale, the regulation directs that the "representative market or field price" (RMFP) be used to determine the depletable "gross income from the property." The RMFP is unrelated to the producer's actual sales price, but rather is a "representative" price derived from market data for comparable oil or gas sold in the immediate vicinity of the well. *See, e.g., Shamrock Oil & Gas Corp. v. Commissioner*, 35 T.C. 979, 1038-40 (1961), *aff'd*, 346 F.2d

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[1] The meaning of the term "gross income from the property," in light of the regulatory definition, is the issue presented in this case. It is therefore misleading for the government to quote that statutory language when it is referring to something else, such as the actual proceeds from sales away from the well. *See* Pet. I, 20.

377 (5th Cir.), *cert. denied*, 382 U.S. 892 (1965). Pet. App. 4a-6a.[2]

2. Exxon is a fully integrated producer of natural gas. Because of the magnitude of its reserves in the Texas Gulf Coast/East Texas area, Exxon built its own gas pipeline system. To support the capital investment in its pipeline, Exxon entered into numerous long-term, fixed-price contracts for the sale of the gas. Exxon processed most of its gas production and then transported the residue gas through its pipeline for sale directly to utilities and other customers. Pet. App. 2a, 37a-38a, 113a-115a.

For many years, natural gas prices were flat, and Exxon's long-term contract prices were favorable. In the early 1970s, however, gas prices rose sharply, and the long-term contracts became a millstone around the company's neck. The contracts required Exxon to supply customers with amounts equal to most of its gas production in the Texas Gulf Coast/East Texas areas at an average price of $.23 per thousand cubic feet (Mcf) for the residue gas (methane), which was well below market. *Id.* at 2a, 116a. Exxon typically sold at market the "non-residue" portion of the gas stream (that is, natural gas liquids processed from the raw gas, such as butane and propane), and its combined actual sales proceeds from both portions of the raw gas stream (netted back to exclude transportation and processing costs) was approximately $.30/Mcf. *Id.* at 119a.

3. In keeping with its consistent practice in earlier years, Exxon calculated its percentage depletion deduction for 1974 in accordance with the dictates of Treas. Reg. § 1.613-3(a). Because the gas transported through its

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[2] The depletion allowance is subject to a limitation that it cannot exceed 50 percent of the "taxable income from the property" (that is, "gross income from the property" less expenses). 26 U.S.C. § 613(a); 26 C.F.R. § 1.613-5(a). This case concerns only the starting point of the calculation, the "gross income from the property." The taxable income limitation is not at issue.

pipeline was not sold in the "vicinity of the well," Exxon based its depletion deduction for that gas on an RMFP—that is, a weighted average price derived from sales by all producers—rather than on Exxon's own sales prices. As a result of the rapidly rising market, 1974 marked the first time that the average wellhead sales price reflected by the RMFP (estimated at that time as $.36/Mcf and found after trial to be $.39/Mcf) exceeded the ($.30/Mcf) price derived from Exxon's "downsteam" gas sales away from the well. Pet. App. 3a, 25a.

The Commissioner disallowed $11.1 million of Exxon's depletion deduction (increasing its tax liability by $5.3 million), asserting that Exxon was required to use as its depletable income the $.30/Mcf figure derived from its actual sales proceeds (netted back to exclude transportation and processing costs), rather than an RMFP. In so doing, the Commissioner treated the RMFP provision as a one-way street that should be used only where it would *reduce* the taxpayer's deduction. The Commissioner on audit had initially proposed to use the same "net-back" approach for Exxon's 1968-73 taxable years as for 1974, but he changed his mind and concurred with Exxon's use of an RMFP for the earlier years when he discovered that a "net-back" approach would *increase* Exxon's deduction for those years. Pet. App. 8a, 45a.

4. Exxon paid the asserted deficiency and brought this suit for a refund in the Court of Federal Claims. The government filed a pretrial motion for judgment on the pleadings addressed to the issue it now seeks to present to this Court, arguing that, as a matter of law, a taxpayer may not base its depletion deduction on an RMFP that exceeds its own sales proceeds for the gas. The court denied this motion in an extensive opinion. Pet. App. 33a-84a.

The court found that the text of the governing regulation plainly requires use of an RMFP for gas transported prior to sale, without regard to whether the RMFP ex-

ceeds actual sales proceeds. The court observed that the regulatory text had remained essentially unchanged for 60 years, despite numerous opportunities to amend it (*see* Pet. App. 58a-59a, 66a & n.17), and stated that the court was not going "to rewrite it." *Id.* at 70a. Looking at the regulation's history, the court explained that its "plain meaning is . . . supported by its evolution. . . . There is no persuasive indication that Congress intended sales prices of the gas to be determinative or that sales prices constituted a ceiling above which no deduction could be allowed." *Id.* at 59a-60a. The court also examined the issue from a policy standpoint and concluded that "the plain language of the regulation produces a rational, intended tax rule . . .; [Exxon's] interpretation of the regulation, as opposed to the government's, makes more sense in the context of depletion deductions." *Id.* at 61a.

The case then proceeded to trial on the contested factual issue—the amount of the 1974 RMFP. The court ruled for the government after trial. Pet. App. 85a-171a. In its opinion, the court first reaffirmed its prior rejection of the government's position that a taxpayer cannot use an RMFP that exceeds its own actual sales proceeds. *Id.* at 120a-131a. The court criticized the government's position as improperly requiring "the court, in essence, . . . to read into the regulation a cap on the RMFP or hold that the regulation as written is invalid whenever an RMFP exceeds the sales price." *Id.* at 123a.

The court nonetheless ruled for the government on two other grounds. It held that Exxon had failed to meet its burden of proof of an RMFP because the wellhead price data it used to support its proposed RMFP of $.41/Mcf was overinclusive. *Id.* at 135a-167a. It also held that the RMFP was not "reasonable according to the facts of this case." *Id.* at 167a-170a.

5. The court of appeals reversed. Pet. App. 1a-30a. The government's primary argument on appeal was to

defend the judgment below on the same theory raised in the petition but rejected by the trial court—namely, that a taxpayer can never use an RMFP that exceeds its actual sales proceeds. The court of appeals, however, "agree[d] with the Court of Federal Claims that neither prior case law, nor the language of the statute, nor its legislative history limits an otherwise valid RMFP to actual gross income." Pet. App. 17a.

The court first observed that the governing regulation had been consistently construed as establishing the general principle that, for sales away from the well, "the RMFP approach must be used whenever a representative price can be established." *Id.* at 8a, *citing Hugoton Prod. Co. v. United States*, 315 F.2d 868, 873 (Ct. Cl. 1963) (*Hugoton I*). Turning to the statutory and regulatory language, the court found that "the plain language of the tax scheme supports Exxon's contention." Pet. App. 13a. The court noted that the text of the regulation contained no language purporting to limit the RMFP to actual proceeds, and it described this omission as having "added importance because it is clear that the Secretary was aware of the possibility that the field price could exceed actual revenues." *Id.* In particular, the court observed that, for hard minerals, the Secretary had created by regulation a rebuttable presumption that such an RMFP in excess of actual sales proceeds was not "representative," but had withdrawn a proposal to apply the same rule to oil and gas. *Id.* at 13a-14a. Finally, the court found that use of an RMFP for all sales away from the well is consistent with the statutory objective of basing depletion on the wellhead value for the gas, excluding subsequent changes in that value attributable to downstream events like processing and transportation. *Id.* at 14a-17a.

The court of appeals also rejected the grounds relied upon by the trial court for its judgment. First, the court ruled that Exxon had carried its burden of proof because a subset of the wellhead sales data on which it relied was undeniably sufficient to prove an RMFP. Pet. App. 23a-

25a. Second, the court of appeals ruled that a court is not permitted "to conduct an independent reasonableness inquiry once an RMFP has been established." *Id.* at 29a. The government does not challenge either of these rulings in its petition.

ARGUMENT

The petition for certiorari advances no credible basis for further review of this case. The question presented, involving the depletion allowance for integrated oil and gas producers that was repealed for years after 1974, is of no continuing significance apart from the pending disputes between the government and Exxon. There is no conflict in the circuits, and, indeed, the decision below fully accords with prior Court of Claims authority construing the applicable regulation. Moreover, the decision below is clearly correct because the text of the regulation cannot possibly support the government's proffered construction, and there is no historical, policy, or other reason for failing to give effect to the regulation's plain terms.

I. THERE IS NO REASON FOR SUPREME COURT REVIEW OF THE DECISION BELOW

1. The government declares that this case presents a "recurring" issue because "other taxpayers can be expected to assert similar claims for inflated depletion deductions." Pet. 10-11. There is no basis whatsoever for this declaration of continuing importance. The percentage depletion allowance for oil and gas wells was repealed, with limited exceptions, more than 20 years ago. 26 U.S.C. § 613A(a); Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501, 89 Stat. 47; *see generally* H.R. Conf. Rep. 94-120, 94th Cong., 1st Sess. 67-68 (1975). One exception was a "grandfather clause" permitting a depletion allowance for gas sold under fixed contracts in effect on February 1, 1975. 26 U.S.C. § 613A(b). That grandfather clause, however, has little or no future significance since the con-

tracts it encompasses surely have expired; thus, the percentage depletion allowance is no longer available to integrated producers.

The government suggests (Pet. 5 n.1) that the issue presented here is not completely "dead" because of the exception for small independent producers and royalty owners. 26 U.S.C. § 613A(c). But even the relatively small depletion allowances available to such taxpayers do not implicate the issue in this case because they would not involve an RMFP, but rather would be calculated under the first sentence of the regulation using the actual wellhead sales price. As the government notes (Pet. 6), a " 'non-integrated' producer typically sells natural gas in an unprocessed state at the well-head," and royalty revenues are treated as wellhead sales because the royalty is paid for extraction of raw mineral. As a practical matter, therefore, it is highly unlikely that the issue presented here will ever arise in the future. The government does not contend that there are any cases pending with another taxpayer involving this issue, and we are aware of none. In short, the question presented in the petition has no significance whatsoever apart from Exxon's existing tax litigation.

2. The government observes that, because of the grandfather clause, the RMFP issue remains alive for several of Exxon's post-1974 tax years, which involve substantial tax liabilities. Pet. 10. The petition, however, studiously avoids making the connection necessary to sustain its assertion of "fiscal importance." *Id.* It does not state that the Federal Circuit's decision here resolves the issue presented for other tax years, and, indeed, the government has taken the opposite position in the lower courts. In its February 5, 1997, answer to Exxon's complaint regarding the 1975 tax year, the government denied the allegation that "Exxon is entitled to percentage depletion . . . based on the applicable representative market or field price for the gas [citing the Federal Circuit's decision below]." Complaint in No. 96-688T, Court of Federal

Claims, ¶ 8(d) (filed Oct. 30, 1996). Unless the government is prepared to acknowledge that this Court's disposition would be controlling for other years, its assertion of "fiscal importance" should be ignored.

In any event, the government can hardly argue that certiorari is appropriate just to resolve a large monetary dispute with a single taxpayer, when it takes the opposite position when the shoe is on the other foot. For example, when Exxon sought review of a judgment that exceeded $2 billion, the government remarked dismissively that "mere monetary size . . . does not entitle [Exxon] to further review in the absence of a legal issue of sufficient *general* significance." Brief for the United States in Opposition at 16 n.14, *Exxon Corp. v. United States*, 474 U.S. 1105 (1986) (No. 85-429) (emphasis added). That observation is equally apt when the government is the petitioner.

3. The government argues that a "conflict" between the decision below and an interlocutory decision of the Tax Court "warrants this Court's review." Pet. 16. A conflict between a court of appeals decision and a trial court decision, however, does not provide a reason for intervention by this Court. *See* Sup. Ct. R. 10.1. Indeed, the conflict may disappear upon appeal of the trial court's decision.

Moreover, the asserted conflict does not bear on the question presented in the petition. Although the Tax Court did grant summary judgment for the government in Exxon's 1979 case, the court did not embrace the government's contention here that an RMFP cannot exceed the actual sales proceeds for the gas. To the contrary, as the Court of Federal Claims noted (Pet. App. 130a-131a), the Tax Court specifically stated that "[t]here may be particular situations in which it is reasonable based upon the 'peculiar facts' to allow the use of the RMFP even where it exceeds the taxpayer's actual gross income." *Exxon v. Commissioner*, 102 T.C. 721, 744 n.28 (1994).

Rather, the Tax Court ruled for the government because it found that the RMFP method was "unreasonable," as compared to the Commissioner's proposed "net-back" method, on the particular facts before it. *Id.* at 744 & n.28. The court explained that substituting its view of reasonableness for the rule established by Treas. Reg. § 1.613-3(a) was justified by the language of 26 U.S.C. § 611(a), which "provides for a 'reasonable allowance for depletion' under the 'peculiar conditions in each case.'" 102 T.C. at 744. As the court of appeals held, however, this assertion of judicial authority is untenable and, indeed, contrary to precedent of this Court. *See* Pet. App. 26a-29a; *Commissioner v. Portland Cement Co.*, 450 U.S. 156, 171 n.20 (1981). The government does not dispute the Federal Circuit's holding on this point. Thus, even the Tax Court has not subscribed to the position the government advances in its petition, and there is no reason for this Court to grant certiorari to entertain it.

II. THE DECISION OF THE COURT OF APPEALS IS CORRECT

A. The Unmistakable Terms of the Governing Regulation Direct the Taxpayer to Use a Representative Market or Field Price to Compute Depletable Income for Sales Away From the Vicinity of the Well

The government does not deny that the outcome of this case is controlled by Treas. Reg. § 1.613-3(a), which is a "legislative" regulation, issued pursuant to an express delegation of Congressional authority in Code section 611, that has "the force and effect of law." *Batterton v. Francis*, 432 U.S. 416, 426 n.9 (1977); *see also Hugoton I*, 315 F.2d at 871 & n.14. The government, however, does not even attempt to advance an interpretation of the text that could support the result it seeks. That is because the text is unequivocal, and its meaning is unmistakable.[3]

[3] The government does contend that the Tax Court found the regulation to be ambiguous. Pet. 14. But the Tax Court's statements in this regard were half-hearted at best, and that court

The regulation describes two methods for computing the "gross income from the property," a calculation designed to estimate the value of the mineral as it comes out of the ground. *See* Pet. App. 51a-57a; 69a-70a; *United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81 (1960); *Signal Gasoline Corp. v. United States*, 77 F.2d 728, 730 (9th Cir. 1935), *cert. denied*, 296 U.S. 657 (1936). For sales in the vicinity of the well, the actual sales price is a direct measure of wellhead value, and the first sentence of the regulation therefore specifies that depletion should be based upon the "amount for which the taxpayer sells the oil or gas." For sales away from the vicinity of the well, however, the actual sales price is not a direct measure of wellhead value because the price is affected by events that may occur "downstream"—such as processing, transportation, and marketing. The second sentence of the regulation specifies that, for such sales, depletion should also be based on a direct measure of wellhead value—the "representative market or field price," which is a weighted average of the prices received industry-wide from wellhead sales of comparable gas in the market area.

The Court of Federal Claims correctly observed that the government's position asks the courts not to interpret the regulation, but to "rewrite it" (Pet. App. 70a) to say something entirely different—namely, that for sales away from the well, "gross income from the property" means *the lesser of* the RMFP or a net-back from the taxpayer's actual sales proceeds. The government's position "contradicts" the regulation as written because the Secretary "has chosen to embody in [the regulation] only one concept—

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never suggested any way to read the regulation to support the government's position. The Tax Court's ruling ultimately rested not on any finding of ambiguity, but on the mistaken views that "there has been considerable erosion of the rule foreclosing inquiry of legislative purpose even in the context of 'clear' language" (*id.* at 728) and that its own notion of reasonableness could override the regulatory definition (*id.* at 744).

'representative market or field price.'" *Hugoton Prod. Co. v. United States*, 349 F.2d 418, 427 (Ct. Cl. 1965) (*Hugoton II*). Even if there were some merit to the government's contention (Pet. 18-21) that the regulation as written is "at odds with" (Pet. 19) the policies of the depletion allowance (and we vigorously disagree (see pages 20-24, *infra*)), "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *Bingler v. Johnson*, 394 U.S. 741, 751 (1969). The legislative regulation is "as binding on the Government as it is upon the taxpayer" (*Weyerhaeuser Co. v. United States*, 395 F.2d 1005, 1008 (Ct. Cl. 1968)), and it unequivocally requires use of the RMFP for all sales away from the well.

B. The Principle of Deference to Administrative Agencies Lends No Support to the Government's Position

1. The government argues that there is no need to engage in the tedious task of reading the regulatory text because the courts must defer to Rev. Rul. 90-62, 1990-2 C.B. 158, an IRS revenue ruling that was issued in the midst of this litigation. Pet. 14, 16-18. This astounding contention is entirely without merit. Indeed, the notion that this ruling controls the outcome here is so far-fetched that the government mentioned the ruling in the court of appeals only in passing and did not have the temerity to argue that it was entitled to any deference or was otherwise relevant to the decision. *See* Gov't C.A. Br. 32. That candid assessment by government appellate counsel of the ruling's insignificance, not judicial error, is the explanation for the Federal Circuit's "failing to defer" to Rev. Rul. 90-62 or "even [to] acknowledge [its] existence" (Pet. 16) in the court's comprehensive opinion.[4]

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[4] In accordance with its longstanding rule against entertaining arguments not presented to the court of appeals, this Court should not even consider the government's administrative deference argument. *See, e.g., G.D. Searle & Co. v. Cohn*, 455 U.S. 404, 412 n.7 (1982); *Duignan v. United States*, 274 U.S. 195, 200 (1927).

This Court has repeatedly noted that revenue rulings "do not have the force and effect of regulations." *Commissioner v. Schleier*, 115 S. Ct. 2159, 2167 n.8 (1995); *Davis v. United States*, 495 U.S. 472, 484 (1990); *see also Biddle v. Commissioner*, 302 U.S. 573, 582 (1938); *Helvering v. New York Trust Co.*, 292 U.S. 455, 468 (1934). Rather, revenue rulings have been described as merely "stat[ing] the institutional litigating position of the Internal Revenue Service." *Armco, Inc. v. Commissioner*, 87 T.C. 865, 868 (1986); *see also Stubbs, Overbeck & Assocs., Inc. v. United States*, 445 F.2d 1142, 1146-47 (5th Cir. 1971); *Halliburton Co. v. Commissioner*, 100 T.C. 216, 232 (1993), *aff'd*, 25 F.3d 1043 (5th Cir.), *cert. denied*, 115 S. Ct. 486 (1994); *Estate of Lang v. Commissioner*, 64 T.C. 404, 406-07 (1975). Even the Tax Court's decision for the government in Exxon's 1979 tax year placed no reliance on Rev. Rul. 90-62, stating that "a revenue ruling is only a statement of [the Commissioner's] position and is entitled to no precedential weight." 102 T.C. at 726 n.8. If the courts had to defer to such pronouncements, particularly when addressed to specific litigation, it would mean the end of a taxpayer's right to litigate tax controversies because the IRS could always prevail by setting forth its litigating position in a pending case in a revenue ruling instead of in a brief.

Whatever deference might be appropriate for a long-standing revenue ruling issued in the normal course, the law is clear that no deference is owed to Rev. Rul. 90-62 because it concededly was issued in response to this litigation. *See* Pet. 18 n.3. Although the government has never before presented this Court with such an extreme invocation of administrative deference principles (*see Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 563 n.7 (1991)), the lower courts have "routinely looked upon such bootstrapping revenue rulings with disfavor," viewing them as no more than "thinly veiled attempt[s] to influence" the pending litigation. *Tandy v. Commissioner*,

92 T.C. 1165, 1170 (1989) (citing *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272, 279 (1966)). The courts refuse to "allow the IRS to take advantage of a self-serving ruling" in this manner. *Niles v. United States*, 710 F.2d 1391, 1393 n.3 (9th Cir. 1983). *See also Somerville v. United States*, 13 Cl. Ct. 287, 290 (1987) ("Revenue rulings issued under such circumstances are of no weight since the government cannot be allowed to bootstrap its own positions"); *St. Louis Bank for Co-operatives v. United States*, 624 F.2d 1041, 1051 (Ct. Cl. 1980).

The government invokes *Smiley v. Citibank (S.D.), N.A.*, 116 S. Ct. 1730 (1996), as authority that deference is owed even to such a "bootstrapping" revenue ruling (Pet. 18 n.3), but that case says nothing of the kind. To the contrary, *Smiley* reiterates the settled rule that the courts owe no deference "to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice." *Id.* at 1733. This Court emphasized the very distinction between agency litigating positions and duly promulgated regulations that the government seeks to obscure. It ruled that deference was appropriate in *Smiley* because "we have before us here a full-dress regulation, issued by the Comptroller himself and adopted pursuant to the notice-and-comment procedures of the Administrative Procedure Act." *Id.* In this case, however, the government relies upon what is nothing more than a publication of the IRS's litigating position in a pending case, unsupported by any evidence of administrative practice and issued without notice and comment. No deference is owed to such a pronouncement.

Moreover, the ruling invoked here lacks the basic hallmarks of reliability that are necessary for deference even to a duly promulgated regulation. Deference is owed to agency interpretations only "so long as the interpretation 'sensibly conforms to the purpose and wording of the regulations.'" *Martin v. Occupational Safety & Health*

Review Comm'n, 499 U.S. 144, 151 (1991), *quoting Northern Ind. Pub. Serv. Co. v. Porter County Chapter of Izaak Walton League of America, Inc.*, 423 U.S. 12, 15 (1975). As noted above, the "interpretation" set forth in Rev. Rul. 90-62 cannot possibly be harmonized with the language of the regulation, and, indeed, the ruling does not discuss the text of the regulation at all.

In addition, the cases relied upon by the government generally call for deference when the agency interpretation is "contemporaneous" or supported by a "long history." *Lyng v. Payne*, 476 U.S. 926, 939 (1986); *Udall v. Tallman*, 380 U.S. 1, 17-18 (1965); *see also Davis v. United States*, 495 U.S. at 484 ("contemporaneous" and "long use"). The regulation at issue here was issued in substantially its current form in 1929 (Pet. App. 93a), and the ruling for which the government seeks deference was issued in 1990, which is hardly a model of contemporaneity. The petition tries to cure this defect by asserting without support that the regulation "conforms to the lengthy and consistent administrative practice under this regulation." Pet. 14. In fact, however, the one-sided rule embodied in Rev. Rul. 90-62 does not conform to prior practice, but rather departs from what the regulatory history shows was the commonly held understanding of the regulation.

2. In 1968, the Secretary addressed the proper use of an RMFP and amended the hard minerals depletion regulation to create a rebuttable presumption that "a price is not a representative market or field price" if the price plus nonmining costs "regularly exceeds the taxpayer's actual sales price of his product." Treas. Reg. § 1.613-4(c)(6). That presumption is rebutted if the taxpayer shows "that the loss on nonmining operations is directly attributable to unusual, peculiar, and nonrecurring factors rather than to the use of a market or field price which is not representative." *Id.* Significantly, the Secretary formally proposed extending the new, more restrictive, hard

minerals rule to cover oil and gas depletion at the same time, but that proposal ultimately was withdrawn, leaving in place the current unqualified language requiring use of an RMFP for all sales away from the well. *See* 36 Fed. Reg. 19256 (1971); 33 Fed. Reg. 10700 (1968). The Secretary's consideration and rejection of this proposed change is simply incompatible with the proposition that the regulation never allowed use of an RMFP in excess of actual sales proceeds. *See* Pet. App. 13a, 58a-60a.[5]

Indeed, the government's position here goes even further than the constraint on use of an RMFP that was added only for hard minerals in 1968. The government now would absolutely prohibit use of an RMFP in excess of sales proceeds for oil and gas depletion, whereas the presumption against such an RMFP in the hard minerals

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[5] Other evidence confirms that the regulation was not understood to bar such an RMFP. At a forum held in 1954, Delbert Williams, then-Chief of the IRS's Natural Resources Section, was asked whether the taxpayer should use an RMFP where, "because of adverse market or other conditions," the price received for sales away from the well was "less than the field price." Mr. Williams replied that it was appropriate in such a situation to use the higher RMFP:

> The Regulations appear to be very clear on that point. Section 39.23(m) of Regulations 118 [now Treas. Reg. § 1.613-3(a)], provides that in the case of any oil or gas not sold on the property but transported therefrom, manufactured or converted into refined product prior to sale, the gross income from such oil for depletion purposes is the representative market or field price before such transportation or conversion.

Oil and Gas Forum, 12 N.Y.U. Inst. on Fed. Tax'n 433, 444-45 (1954). Although this statement by a senior IRS official concerning his area of expertise was not binding on the agency, it certainly belies the government's assertion that there existed a consistent administrative practice that would have prohibited use of an RMFP in the circumstances described. *See also* Priv. Ltr. Rul. 8611008 (Dec. 3, 1985) (construing Treas. Reg. § 1.613-3(a) to require taxpayer to use RMFP that exceeds sales proceeds in determining windfall profit tax removal price).

regulation is rebuttable. Ironically, if the Secretary had added the latter constraint to the oil and gas regulation, that would not have changed the outcome of this case. The RMFP found by the court below is demonstrably a "representative" price because the disparity between that price and Exxon's actual sales proceeds was caused by the combination of a rising market and unfavorable long-term contracts. Thus, Exxon would have rebutted the presumption and been permitted to use its RMFP. *See Bloomington Limestone Corp. v. United States*, 445 F.2d 1105, 1109 (7th Cir. 1971) (downstream losses "caused by depressed market conditions" rebutted the presumption that proposed RMFP was not representative). In sum, there is no support whatsoever for the government's assertion that its litigating position in this case conforms to "a lengthy and consistent administrative practice."

C. The Courts Have Consistently Construed the Regulation as Directing Use of an RMFP for All Sales Away From the Well, Regardless of Actual Sales Proceeds

The Court of Claims had several occasions to consider the meaning of Treas. Reg. § 1.613-3(a). In *Hugoton I*, the court rejected the government's attempt to use the taxpayer's own sales data to calculate percentage depletion for sales away from the well, holding that "if there is [an RMFP], it must govern." 315 F.2d at 871. The court specifically criticized the government's resistance there to using an RMFP where it might benefit a taxpayer, noting that the Commissioner "has chosen the market comparison method, and he has defended its application when productive of larger revenues." *Id.* at 873. In *Hugoton II*, one of the litigants attacked the validity of the RMFP methodology by raising a hypothetical in which, as here, the RMFP exceeded the actual sales proceeds and therefore depletion would be based on "gross income from the property" that "would exceed [the taxpayer's] actual gross income." 349 F.2d at 424.

The court, however, was untroubled by this result, emphasizing that, for sales away from the well, a producer's actual income "is immaterial to the ultimate resolution of the case," and the RMFP is "conclusive [of] the value of [the taxpayer's] gas at the wellhead." *Id.* at 425, 426. Citing this Court's decision in *United States v. Cannelton Sewer Pipe Co.*, the court declared without qualification that, for sales away from the well, the "depletion allowance is intended to be based on the *constructive income* from a raw product . . . not on the value of the finished article." *Id.* at 425.

In *United States v. Henderson Clay Prods.*, 324 F.2d 7 (5th Cir. 1963), *cert. denied*, 377 U.S. 917 (1964), a case involving a hard mineral, the taxpayer claimed an RMFP that exceeded its gross income from the finished product. The court was skeptical of this contention as a factual matter and ultimately rejected it on the ground that the claimed RMFP was not "representative" of the price for which the taxpayer could have sold the raw mineral. *See generally* Pet. App. 8a-10a. Significantly, however, the court in that case did not endorse the legal position the government takes here that an RMFP could not exceed actual sales proceeds if the price in fact was representative. To the contrary, the court remarked that it must be "irrelevant whether, in a particular case," use of an RMFP "will give a higher base or a lower base than the gross income from the finished product will yield." 324 F.2d at 12.

In short, long before this case arose, the courts repeatedly indicated their understanding that Treas. Reg. § 1.613-3(a) means what it says and requires an RMFP for all sales away from the well, regardless of actual sales proceeds. Moreover, the Court of Claims specifically invited the Commissioner to "amend the applicable Regulation" if he was troubled by the operation of the RMFP mechanism. *Hugoton II*, 349 F.2d at 430. The Commissioner accepted that invitation in the hard minerals

area, where it is generally harder to determine an RMFP than for oil and gas. *See Henderson,* 324 F.2d at 15; pages 15-16, *supra*. He declined the invitation, however, with respect to oil and gas depletion, and it is not the province of the courts "to legislate in his place" and create a limitation on the use of an RMFP that cannot be found in the regulation. *Hugoton II,* 349 F.2d at 430.

D. The Regulation as Written Is Fully Consistent With the Statute

The government argues that its position, as reflected in Rev. Rul. 90-62, should be accepted because it "conforms the text of the regulation with the text of the statute." Pet. 14. *See also* Pet. 21-22. The government reasons that the meaning of the term "gross income from the property" in the depletion provisions must be "consistent with [the] ordinary meaning" of "gross income" in section 61(a) of the Code, which refers to a taxpayer's actual income. Pet. 21. This simplistic view of "gross income from the property," however, is obviously untenable. The government's own reading of the regulation contemplates that gas sold away from the well normally will be depleted on the basis of an RMFP, not actual proceeds from sales away from the well. Indeed, that is the essence of this Court's decision in *Cannelton:* "Congress intended to grant miners a depletion allowance based on the *constructive* income from the raw mineral product." 364 U.S. at 86 (emphasis added). Thus, the government's argument contradicts one of the fundamental features of the longstanding depletion framework.

The lower courts have expressly rejected the notion that the term "gross income from the property" in section 613(a) should be construed by reference to section 61, instead of being regarded as a term defined by regulation. "[T]he only definition of gross income or means of calculating gross income that exists with respect to oil and gas properties is found in the regulations under § 613(a),"

and that definition "does not attempt to measure actual income." *Transco Exploration Co. v. Commissioner*, 949 F.2d 837, 839, 841 (5th Cir. 1992). Net income for depletion purposes "is a term to be construed in the light of the regulations and the statute" while "net income for the general purposes of the Code . . . is subject to a much broader interpretation." *Island Creek Coal Co. v. Commissioner*, 30 T.C. 370, 385 (1958). *See also Helvering v. Wilshire Oil Co.*, 308 U.S. 90, 102 (1939).

The three cases cited by the government (Pet. 21) are not to the contrary. Each of these cases involved royalty owners or mineral sold at the well and therefore were governed by the first sentence of the regulation, which defines "gross income from the property" in that situation in terms of actual sales proceeds. In calculating depletion using the "ordinary meaning" (Pet. 21) of "gross income," the courts were simply *applying* the text of the regulation, and the cases cast no aspersions on similarly applying the text of the second sentence of the regulation for gas sold away from the well.

E. The Regulation as Written Accords With the Policies of the Depletion Provisions

Finally, the government contends that the decision below does not conform with the "object of the depletion provisions of the Code." Pet. 18. Even if there were some merit to this contention, it would not give the courts a license to amend a legislative Treasury regulation. *See, e.g., Transco Exploration Co. v. Commissioner*, 949 F.2d at 841 (court has no authority "to amend the regulations judicially to avoid" a particular result); *Honeywell v. Commissioner*, 87 T.C. 624, 635 (1987). In fact, however, the contention is insubstantial because the regulation as written is fully consistent with the policies of the depletion provisions.

1. The government states that the RMFP provision "serves two related functions." Pet. 12. The first assert-

edly is to "ensure[] that a taxpayer may not include in its depletable income any value that was *added* to the oil or gas *after* extraction by processing, conversion or transportation." *Id.* (emphasis added). This function could more properly be stated in a neutral fashion—to ensure that depletable income reflects the value of the gas in its raw state at the well, unaffected by downstream enhancements *or decrements*. Certainly the cited reference does not suggest that the RMFP rule should not be applied neutrally; it states without qualification that "the field price of the oil or gas at the well indicates the income from the property." *Hearings Before the Joint Committee on Internal Revenue Taxation*, 71st Cong., 3d Sess. 104, 111 (1930) (testimony of B.H. Bartholow).

Nor does the government give any logical reason why the RMFP rule should not be applied neutrally. Use of a "constructive income" figure for sales away from the well implements the broad purpose of the percentage depletion provisions—to provide a simplified method of giving the producer a return of capital based on the value of the mineral upon extraction. *See* Pet. App. 17a; 53a-54a; *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459, 466-67 (1933); *Hugoton I*, 315 F.2d at 869. The government does not explain why this purpose is undermined by evenhanded application of the RMFP rule. That approach makes the producer base its depletion on the wellhead value; as the court of appeals noted, it does not allow the producer to include value added by processing and transportation. Pet. App. 16a. Conversely, the government's proposed one-sided rule would undermine the goal of percentage depletion because in some cases it would deny producers an allowance based on the full wellhead value.

The second policy identified by the government is "to ensure that integrated producers are not treated better than nonintegrated producers." Pet. 12. Again, this is

a one-sided statement of a neutral policy. The depletion provisions seek to place the integrated producers on a par with non-integrated producers, treating the integrated producers "as if the operator were selling the mineral mined to himself for fabrication." *Cannelton*, 364 U.S. at 89. The RMFP mechanism achieves that goal because the RMFP represents the weighted average wellhead price, thus making the integrated producer base its depletion on the same wellhead price received by the "average" non-integrated producer. *See* Pet. App. 17a n.8; *Hugoton I*, 315 F.2d at 876. The parity policy is not advanced by preventing taxpayers from using the RMFP when it exceeds actual sales proceeds. That rule would force the integrated producer to base its depletable income on an amount lower than that used by the average non-integrated producer, which would "give a preference to the non-integrated miner . . . and [would] reintroduce, in reverse, the tax discrimination between integrated and non-integrated miners against which the whole tenor of the *Cannelton* opinion is directed." *United States v. Henderson Clay Prods.*, 324 F.2d at 12.

The government takes a skewed and myopic view in arguing that the decision below conflicts with this parity policy. The government finds a "competitive advantage" for integrated producers because they can base their depletion on an amount that exceeds their actual sales proceeds, whereas non-integrated producers must look to their actual revenues. Pet. 20-21. But it is equally true that integrated producers sometimes must base their depletion on an amount that is *lower* than their actual sales proceeds, whereas non-integrated producers are never forced to do so. That is the fundamental structure of the regulation—non-integrated producers use actual income for their wellhead sales and integrated producers use constructive income for their sales away from the well. When that structure is applied evenhandedly, as the court of appeals found appropriate, there is parity on

average between integrated producers and non-integrated producers. When the structure becomes a one-way street, as the government proposes, integrated producers are treated less favorably, on average, than non-integrated producers.

2. The government also asserts that "the depletion provisions seek . . . to preclude a taxpayer from using the depletion deduction to offset profits from a separate line of business." Pet. 18. Strictly speaking, this policy goal is not implicated here because its source is the legislative history of the "taxable income limitation," which is not at issue in this case. *See* Pet. App. 90a; S. Rep. No. 275, 67th Cong., 1st Sess. 15 (1921); note 2, *supra.*

In any event, this policy concern, like depletion generally, is not concerned with downstream events. In full accord with the Congressional sources of the policy goal asserted in the petition, "constructive income" at the well has always been the point of reference in computing the taxable income limitation for sales away from the well. *See, e.g.*, Staff of the Joint Committee on Internal Revenue Taxation, Vol. I, Pt. 2, 69th Cong., 1st Sess., *Preliminary Report—Depletion—Oil and Gas Revenue Act of 1926*, at 13 (Comm. Print 1927) ("*Depletion Report*"). Thus, the computation occurs at the wellhead without any reference to events that occur downstream, such as gains or losses suffered by an integrated producer in marketing its product away from the well. "Taxable income *from the property*" is simply "gross income *from the property* as defined in . . . § 1.613-3" minus the expenses of extraction. Treas. Reg. § 1.613-5(a). Indeed, the pertinent legislative history flatly declares that the "net-back" approach the government seeks to use here is impermissible: for sales away from the well, "the gross receipts from a refined and transported product *cannot be*

used in determining the income." *Depletion Report*, at 13 (emphasis added).[6]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

ROBERT L. MOORE, II
Counsel of Record
THOMAS D. JOHNSTON
EMMETT B. LEWIS
ALAN I. HOROWITZ
MILLER & CHEVALIER,
Chartered
Metropolitan Square
655 Fifteenth Street, N.W.
Washington, D.C. 20005
(202) 626-5800

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[6] The government plucks some numbers from the record on summary judgment in Exxon's 1979 Tax Court case that supposedly "illustrat[e]" how the decision below contravenes this policy. Pet. 19-20. This illustration ignores the fact that the policy underlying the taxable income limitation is focused on production income at the well, not downstream events, and therefore actual sales proceeds are irrelevant. In any case, the numbers do not even support the government's erroneous characterization of the policy. The government's illustration includes income only from gas sales, but it is well settled that the taxable income limitation takes into account income from all minerals produced on the property. *Louisiana Land & Exploration Co. v. Commissioner*, 102 T.C. 21, 57 (1994). When the oil income from the property is included, the gross income from the property will greatly exceed the claimed depletion allowance.